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First-Mover Advantage: The Theory Is Only as Good as Its Assumptions

By Sean Collins

In a recent *ICI Viewpoints*, we promised to briefly revisit some of the concerns we've long voiced about the theoretical underpinnings of the *first-mover hypothesis*. That is, the notion that fund investors may redeem en masse during market downturns to avoid the possibility of other investors redeeming heavily, thereby diluting shareholder returns.

In economics, as in the hard sciences, theories depend on assumptions. To take an example from physics, the theory of gravity states that *in a vacuum* a feather and an iron ball will fall at the same rate, but dropped from the top of a building the iron ball will land first because the objects *aren't* in a vacuum. Thus, assumptions can matter a lot.

We've noted troubling aspects about the assumptions underlying the first-mover hypothesis, including that:

- **Taxes are assumed to be zero**. In fact, income taxes on capital gains can make redeeming less appealing.
- **Funds are depicted as if they all react to market downturns by selling assets**. In fact, some funds are likely buying, or trying to buy, securities that they feel are undervalued.
- **There's a sense that fund shareholders all redeem—or try to—during market downturns**. We've shown many times that investor behavior is in fact diverse. For example, even during the most severe market declines, some investors buy fund shares and most others stand pat.
- **Fund investors are assumed to react radically to market conditions, selling massively during downturns**. In fact, the vast majority of mutual funds shareholders are retail investors saving for retirement and other long-term goals, giving them the ability to look through market slumps.
- **Reinvestment risk is ignored**. The first-mover hypothesis in effect assumes that redeeming out of a fund is costless—you get out because you're worried about other investors redeeming ahead of you, and that's that. In reality, if you redeem out of a fund, you have to decide when to reenter the market—remember, most fund investors are saving for the long-haul. Even being out of the market just one day could lead you to miss a significant market rebound. Put simply, redeeming out of a fund is itself a risky proposition, something the first-mover hypothesis ignores.
- **There is no allowance for professional financial advice**. Professional financial advice doesn't figure at all in the first-mover hypothesis. In fact, it likely has a significant calming effect on shareholder behavior, as financial advisors often remind clients to stick to their investment plans rather than sell in panic.

To read more about these points, we recommend the following:

S. Collins and C. Plantier (2014), "Are Bond Mutual Fund Flows Destabilizing? Examining the Evidence from the 'Taper Tantrum'."

ICI Viewpoints (2016a), "Matching Models to Reality: Doomsayers Are Disappointed—Again—as Funds Weather Brexit Shock."

ICI Viewpoints (2016b), "Matching Models to Reality: The Real-World Challenges to Regulators' 'First-Mover' Hypothesis."

ICI Viewpoints (2016c), "Matching Models to Reality: In a Falling Market, the Real "Movers" May Be...the Buyers."

ICI Viewpoints (2016d), "Matching Models to Reality: Bond Market Investors Don't Follow the "First-Mover" Script."

ICI Viewpoints (2021), "Bond Mutual Fund Outflows: A Measured Investor Response to a Massive Shock"

S. Collins (2016), Presentation, Atlanta Fed 2016 Annual Financial Markets Conference—Getting a Grip on Liquidity: Markets, Institutions, and Central Banks.

ICI Viewpoints (2022), "Navigating Through Financial Storms: American Savers' Handling of Retirement Planning Through COVID."

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